ASSEMBLY

22 February 2017

Title: Treasury Management Strategy Statement 2017/18	
Report of the Cabinet Member for Finance, Growth and Investment	
Open Report	**For Decision**
Wards Affected: None	**Key Decision:** Yes
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Accountable Strategic Director: Claire Symonds, Chief Operating Officer	

Summary

This report deals with the Treasury Management Annual Strategy Statement, Treasury and Prudential Indicators, Annual Investment Strategy and borrowing limits, in compliance with Section 15(1)(a) of the Local Government Act 2003.

The production and approval of a Treasury Management Annual Strategy Statement and Annual Investment Strategy are requirements of the Council under Section 15(1) of the Local Government Act 2003. It is also a requirement of the Act to set an authorised borrowing limit for the forthcoming financial year.

The Local Government Act 2003 also requires the Council to have regard to the Prudential Code, and to set prudential indicators which consider the Council's capital investment plans for the next three years.

The Cabinet considered and endorsed this report at its meeting on 13 February 2017.

Recommendation(s)

The Assembly is recommended to adopt the Treasury Management Strategy Statement for 2017/18 and, in doing so, to:

(i) Note the current treasury position for 2017/18 and prospects for interest rates, as referred to in section 6 of the report;

(ii) Approve the Council's Borrowing Strategy, Debt Rescheduling Strategy and Policy on borrowing in advance of need for 2017/18 as referred to in section 9 of the report;

(iii) Approve the Annual Investment Strategy and Creditworthiness Policy for 2017/18 outlining the investments that the Council may use for the prudent management of its investment balances, as set out in Appendix 1 to the report;

(iv) Approve the Authorised Borrowing Limit of £902m for 2017/18, representing the statutory limit determined by the Council pursuant to section 3(1) of the Local Government Act 2003, as set out in Appendix 3 to the report;

(v) Approve the Treasury Management Indicators and Prudential Indicators for 2017/18, as set out in Appendix 3 to the report;

(vi) Approve the Minimum Revenue Provision Policy Statement for 2017/18, representing the Council's policy on repayment of debt, as set out at Appendix 4 to the report;

(vii) Maintain the delegated authority to the Chief Operating Officer, in consultation with the Cabinet Member for Finance, Growth and Investment, to proportionally amend the counterparty lending limits agreed within the Treasury Management Strategy Statement to take account of any increase in cash from borrowing and any subsequent decrease in cash balances as payments are made to the Special Purpose Vehicle;

(viii) Agree to review the delegated responsibility as part of the 2017/18 Treasury Management Outturn Report;

(ix) Approve a loan of up to £3.5m to Be First, which is the new Council-owned company to manage the delivery of the Borough regeneration agenda;

(x) Approve a loan of up to £150,000 for Traded Services;

(xi) Agree to delegate authority to the Chief Operating Officer, in consultation with the Cabinet Member for Finance, Growth and Investment, to agree contractual terms, including the rate, duration and security as part of the loan agreements with Be First and Traded Services; and

(xii) Note that further reports would be presented to the Cabinet in the event that the required working capital loans for Be First and Traded Services exceed the limits set out above.

Reason(s)

To enable the Council to accord with the requirements of the Local Government Act 2003.

1. Introduction and Background

1.1 The Council is required to operate a balanced budget, with cash raised during the year sufficient to meet the Council's cash expenditure. Treasury management supports the Council by seeking to ensure its cash flow is adequately planned, with cash being available when it is needed. Surplus cash is invested in counterparties or instruments commensurate with the Council's risk appetite, providing adequate security and liquidity while also considering the investment return.

1.2 A second function of treasury management is funding the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses.

1.3 The Council is responsible for its treasury decisions, activity and risk appetite. The successful identification, monitoring and control of risk are integral elements of treasury management, including credit and counterparty risk, liquidity risk, market risk, interest risk, refinancing risk and legal and regulatory risk. The Council is statutorily required to approve the Treasury Management Strategy Statement (TMSS) prior to the new financial year.

2. Reporting Requirements

2.1 The Council is required to receive and approve at least three main treasury reports each year. These reports are required to be adequately scrutinised by Cabinet before being recommended to the Council. The three main treasury reports are:

i. **The Treasury Management Strategy Statement (TMSS)** is the most important report and considers the impact of the Council's proposed Revenue Budget and Capital Programme on the Balance Sheet position, the current and projected Treasury position, the Prudential Indicators (PIs) and the outlook for interest rates. In addition, the current market conditions are factored into any decision-making process.

ii. **An Annual Treasury Report** which outlines the actual PIs, treasury indicators and treasury operations compared to the estimates within the strategy.

iii. **A Mid-Year Treasury Management Report** to update Members on the progress of the capital position, amending PIs and investment strategy as necessary.

2.2 As the Council is responsible for housing, PIs relating to capital expenditure, financing costs and the Capital Financing Requirement (CFR) are split between the Housing Revenue Account (HRA) and the General Fund (GF). The impact of new capital investment decisions on housing rents will also need to be considered.

2.3 This report provides an explanation of the key elements of the Council's Treasury Management Strategy, its Minimum Revenue Provision (MRP) Strategy, the Annual Investment Strategy (AIS) for 2017/18 and the borrowing strategy, which are set out in detail in the appendices attached to this report.

3. Treasury Management Strategy for 2017/18

3.1 The Local Government Act 2003 and supporting regulations require the Council to have regard to the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next three years and ensure the Council's capital programme is affordable, prudent and sustainable.

3.2 The Act requires councils to set out their treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by investment guidance issued after the Act). This sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

3.3 The Council has adopted the Department of Communities and Local Government (DCLG) investment guidance that came into effect from 1 April 2010. The strategy for 2017/18 covers two main areas:

Treasury Management Issues

- Current Portfolio Position;
- Treasury Position at 31 December 2016;
- Medium term capital finance budget;
- Treasury Management Advisors;
- Economic Update and Rate Forecast;
- Strategy Amendments;
- The Annual Investment Strategy and Investment Policies;
- The Capital Expenditure Plans 2017/18 – 2019/20;
- The Council's Borrowing Strategy and Borrowing Requirement; and
- Treasury indicators which limit the treasury risk and activities of the Council.

Capital Issues

- The capital plans and the prudential indicators; and
- The minimum revenue provision (MRP) strategy.

4. Current Portfolio Position

4.1 The Council holds cash balances arising from its operational activities, including income from grants and Council Tax, which are offset by expenditure to run services. The timing of these cash flows can result in surplus cash which is then available to invest. Cash balances are also affected by "working capital", which relates to amounts of outstanding payments to be made to suppliers offset by amounts owed to the Council.

4.2 The Council's year-end (31 March) cash balances since 2012/13 are shown below:

2016/17 - £170m (estimate)
2015/16 - £220m
2014/15 - £218m
2013/14 - £120m
2012/13 - £110m

4.3 These balances are made up of the following sources of cash:

- Capital grants and Section 106 funds received in advance of expenditure;
- General Fund, HRA and School cash balances;
- Earmarked Reserves and provisions;
- Capital Receipts and Working Capital;
- European Investment Bank Loans to fund regeneration;
- Green Investment Bank to fund energy company expenditure;
- Public Works Loan Board (PWLB); and
- bank loans including Lender Option Buyer Option Loans (LOBO).

4.4 Table 1 below shows the Council's investments and borrowing balances as at 31 December 2016, including the Average Life and the Rate of Return. The loans have been split between HRA borrowing and GF borrowing to match the two pool approach the Council has adopted for borrowing. The Council invests all cash in one investment pool, with interest distributed between the HRA, schools and GF.

4.5 Members should be aware that the high level of short-term borrowing (£128.9m as at 31 December 2016) does significantly reduce the Average Life and the Rate of Return for General Fund as well as increase the total value of the investments held.

Table 1: Council's Treasury Position at 31 December 2016

	Principal Outstanding £000s	Rate of Return %	Average Life (yrs.)
General Fund Fixed Rate Borrowing			
PWLB	60,000	2.52	46.2
Market Loans	119,000	2.66	32.9
Short Term Borrowing	128,893	0.30	0.3
Total General Fund Debt	**307,893**	**1.64**	**21.8**
Housing Revenue Account Fixed Rate Borrowing			
PWLB	265,912	3.50	39.3
Market Loans	10,000	3.98	61.7
Total Housing Revenue Account Debt	**275,912**	**3.51**	**40.1**
Total Council Borrowing	**518,860**	**2.81**	**34.2**
Investments			
Bank Deposit	130,000	1.07	0.79
Local Authority	62,291	1.12	0.38
Certificates of Deposit	75,000	1.52	1.27
Money Market Funds	13,250	0.34	0.01
Other Investments*	12,251	4.22	1.45
Total Investments	**292,792**	**1.29**	**0.78**

* other investments include a prepayment to the pension fund, a loan to the Barking Riverside limited and loans to schools.

4.6 **Medium Term Capital Finance Budget**

A key part of the Council's budget strategy is the medium-term capital finance budget shown as Table 2. It is a statutory requirement that the level of borrowing is kept under review and is affordable. As a result of the Council's restructure, it is likely that the Council's cash position will significantly reduce over the next few years as a result of utilising the Council's reserves but also as a result of using cash balances to fund property investments.

The significant increase in GF Interest Payable is due to the borrowing required to fund the Council's property investments. In 2019/20, property returns should reduce the net cost of borrowing although the value of the income streams have not been calculated at the time of producing this report.

The medium-term capital financing budget to 2019/20 is outlined in table 2 below:

Table 2: Medium Term Capital Finance Budget

£'000s	2016/17 Budget	2017/18 Budget	2018/19 Budget	2019/20 Budget
MRP	5,227	6,174	8,833	9,951
GF Interest Payable	2,251	4,151	5,651	7,151
HRA Interest Payable	10,059	10,059	10,059	10,059
Interest Income	(2,570)	(2,570)	(2,570)	(2,570)
Reside 2 Returns	(518)	(1,913)	(1,860)	(1,806)
Net Cost	14,449	15,901	20,113	22,785

4.7 Treasury Position at 31 December 2016 and Forward Projections

4.7.1 The Council's treasury portfolio position at 31 December 2016, with forward projections are summarised in table 3. The table shows the actual external debt against the underlying capital borrowing need (CFR), highlighting any over or under borrowing. The CFR and the Gross Debt includes borrowing to fund the first Barking & Dagenham Reside scheme as well as the borrowing from the EIB to fund Abbey Road Phase 2 and the Gascoigne Regeneration.

Table 3: Treasury Position at 31 March 2016, with Forward Projections

£'000s	2015/16 Actual	2016/17 Estimate	2017/18 Estimate	2017/18 Estimate	2018/19 Estimate
External Debt					
Debt at 1 April	315,912	394,912	454,912	504,912	524,912
Expected change in Debt*	79,000	60,000	50,000	20,000	0
Other long-term liabilities	58,078	55,245	52,308	49,407	47,707
Reside 1 Debt	84,847	84,481	84,100	83,703	83,291
Gross Debt at 31 March	**537,837**	**594,638**	**641,320**	**658,022**	**655,910**
CFR	**587,051**	**641,143**	**658,242**	**658,233**	**656,344**
Under / (over) borrowing	**49,214**	**46,505**	**16,922**	**211**	**434**

* Debt excludes short-term borrowing

5. Treasury Management Advisors

5.1 The Council uses CAS for external treasury advice. However the Council aknowledges that it is ultimately responsibility for all treasury management decisions and will ensure that undue reliance is not placed on the external advisors.

5.2 The Council recognises that there is value in receiving advice from an external treasury advisor in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are documented, and subjected to regular review. For its cash flow generated balances, the Council will utilise a range of investment instruments, as agreed within the Annual Investment Strategy restrictions (appendix 1) in order to benefit from the compounding of interest.

6. Economic Update and Rate Forecast

6.1 On 4 August 2016, the Monetary Policy Committee, (MPC), cut the Bank Rate from 0.50% to 0.25% to counteract a potential sharp slowdown in growth in the second half of 2016 following the vote for the UK to leave the European Union. The cut in rate had a significant impact on reducing the Council's return.

6.2 However, economic data since August has indicated stronger growth than that forecast. In addition, inflation forecasts have risen due to a continuation of the sharp fall in the value of sterling since early August. Consequently, the Bank Rate was not cut again in November and, on current trends, it now appears unlikely that there will be another cut.

6.3 A first increase to 0.50% is tentatively pencilled in for Q2 2019, after negotiations to leave the European Union are forecast to be concluded. However, if strong domestically generated inflation, (e.g. from wage increases within the UK), were to emerge, then the pace and timing of increases in Bank Rate could be brought forward.

6.4 Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK and geopolitical developments, especially in the EU, could have a major impact on the movements of interest rates. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

6.5 The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. It has long been expected that at some point, there would be a start to a switch back from bonds to equities after a historic long term trend over about the last twenty-five years of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial quantitative easing purchases of bonds, added further impetus to this downward trend in bond yields and rising prices of bonds. The opposite side of this coin has been a rise in equity values as investors searched for higher returns and took on riskier assets. The sharp rise in bond yields since the US Presidential election, has called into question whether, or when, this trend has, or may, reverse, especially when America is likely to lead the way in reversing monetary policy.

6.6 Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as strong economic growth becomes more firmly established. The expected substantial rise in the Fed. rate over the next few years may make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise.

6.7 Rising bond yields in the US would be likely to exert some upward pressure on bond yields in other developed countries but the degree of that upward pressure is likely to be dampened by how strong, or weak, the prospects for economic growth and rising inflation are in each country, and on the degree of progress in the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

6.8 PWLB rates and gilt yields have been experiencing high levels of volatility that have been highly correlated to geo-political, sovereign debt crisis and emerging market developments. It is likely that these exceptional levels of volatility could continue to occur for the near future.

6.9 The overall balance of risks to economic recovery in the UK is to the downside, particularly in view of the current uncertainty over the final terms of Brexit and the timetable for its implementation.

6.10 Apart from the above uncertainties, **downside risks to current forecasts** for UK gilt yields and PWLB rates currently include:

- Monetary policy action by the central banks of major economies reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some countries.
- Major national polls including Italy, Spain, Netherlands, France and Germany.
- A resurgence of the Eurozone sovereign debt crisis, with Greece being a problem, and stress from disagreement between EU countries on free movement of people and how to handle a huge influx of immigrants and terrorist threats
- Weak capitalisation of some European banks, especially Italian.
- World geopolitical risks causing a significant increase in safe haven flows.
- UK economic growth and increases in inflation weaker than currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.

6.11 The potential for **upside risks to current forecasts** for UK gilt yields and PWLB rates, especially for longer term PWLB rates, include:

- UK inflation rising to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium in gilt yields.
- A rise in US Treasury yields as a result of Fed. funds rate increases and rising inflation expectations in the USA, dragging UK gilt yields upwards.
- The pace and timing of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- A downward revision to the UK's sovereign credit rating undermining investor confidence in holding sovereign debt (gilts).

The Council has appointed CAS as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Table 3 gives their central view.

Table 3: Interest Rate Forecast for the BOE Base Rate and PWLB

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.60%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
50yr PWLB rate	2.70%	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%

6.12 **Bail In Legislation**

6.12.1 As part of regulation changes within the banking sector the UK Government has removed the expectation that governments will support financial institutions in the event of an institution fail. This was set up to ensure there was a structure that will be followed should a financial institution fail. To do this the UK Government agreed a process to deal with a financial institution failure, which includes the option for institutional investors to lose part of their invested cash as part of a “bail in”.

6.12.2 It could be argued that the potential for institutional investors to lose part of their investment has always been there and is the main driver behind the rates “rewarded” when an investment is made. The structure keeps the equity investor and bond holders at the top with Institutional Investors, therefore there is a significant buffer before the Council’s cash holdings would be affected.

6.12.3 The Treasury section completes regular monitoring of the potential affect a significant market correction would have on the various banks the Council has deposited money with and will make adjustment to the strategy should any issues be identified.

6.13 **Treasury Savings Targets**

6.13.1 Historically the Council has maintained a prudent and low risk treasury investment strategy. This approach has ensured that the Council has not lost money from any of its investments, while achieving a return commensurate with the risk taken. This approach has led to treasury having a significant impact on the Council’s overall funding requirements, both in terms of generating income from investments and from reducing the costs of borrowing to support the Council’s capital programme.

6.13.2 In order for Treasury to support the reduced budgets for 2015/16 to 2017/18, Members agreed a number of savings targets for treasury as outlined in table 4 below, which shows the accumulative effect of the savings. A total of £1.6m worth of savings will have been removed from the annual treasury budget from 2017/18.

6.13.3 For 2015/16 Treasury significantly outperformed the savings target, providing a return of £800k above the revised target, which was used to reduce the impact of overspends in other departments.

Table 4: Treasury Savings Targets for 2015/16 to 2017/18

Saving Reference	Savings Proposal	2015/16 £000	2016/17 £000	2017/18 £000	Total £000
CEX/SAV/27	Increase in Average Return	500	500	250	1,250
CEX/SAV/29	Increase Counterparty Risk	250	0	0	250
CEX/SAV/54e	Increase Duration Risk	100	0	0	100
	Total Savings	**850**	**500**	**250**	**1,600**

6.14 **Return Target 2016/16 to 2017/18**

6.14.1 To achieve the interest, target the treasury section needs to achieve the following average returns on an average cash balance of £160m (excluding EIB cash):

2016/17 1.40%
2017/18 1.60%
2018/19 1.80%
2019/20 2.00%

6.14.2 The increased return is heavily reliant on interest rates increasing from their current near historic lows. The increase does not need to occur in the first half of 2017 as treasury section has secured a return through longer dated investments, which is currently expected to achieve the 1.60% return for 2017/18. However, if rates do not increase by early 2018 then the return target for 2018/19 will be very challenging to meet without significantly increasing the duration risk and / or the counterparty risk.

6.15 **Risk Monitoring**

6.15.1 The Council recognises that ratings should not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment takes account of information that reflects the opinion of the markets.

6.15.2 To this end the Council will engage with its advisors to maintain a monitor on market pricing such as Credit Default Swaps (CDS). However due to the volatility of the CDS market, this will be monitored but will not be included in the investment rating of any financial institutions.

6.15.3 Other information sources used will include the financial press and other such information pertaining to the banking sector to establish the most robust scrutiny process on the suitability of potential investment counterparties.

6.15.4 The aim of the strategy is to generate a list of creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk. The intention of the strategy is to provide security of investment and to minimise risk to the level agreed by Members and included in the Investment Strategy.

7. Strategy Amendments

7.1 Duration Risk

7.1.1 Generally, the longer the duration of an investment the better the return. There are several risks associated with this including:

i. the risk of locking in a low rate for a long period; and
ii. liquidity risks as the cash will not be available for the Council to use.

7.1.2 To achieve the interest income budget set, without taking significant risk, the treasury section increased the duration of several investments during 2016/17 where opportunities arose. This strategy will continue in 2017/18, although the benefit from higher returns will be weighed against the risk of locking in investments at low rates at a time when interest rates may begin to increase.

7.2 Counterparty Risk

7.2.1 During 2017/18 the Council will continue to use the creditworthiness service provided by its advisor, CAS, which employs sophisticated modelling utilising credit ratings from the main credit rating agencies (Fitch, Moody's and Standard & Poor's. The credit ratings of counterparties are supplemented with the following overlays:

i. credit watches and credit outlooks from credit rating agencies;
ii. Sovereign ratings to select counterparties from only creditworthy countries.

7.2.2 This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system for which the product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. The Council uses these colour codes to guide the suggested duration for investments and are outlined in detail in Appendix 1 section 16.

7.2.3 The financial institutions the Council invests with all have credit ratings and as a rule, the lower the credit rating the higher the return. The Council has historically had a prudent, although not completely risk adverse, approach to treasury investments. The Council has agreed that to increase investment income treasury will be able to take additional risk. The additional risk being taken include:

i. Maintain the Royal Bank of Scotland limit for deals at £70m with a maximum duration of three years.
ii. Remove the specific limit for Certificate of Deposits.
iii. Increase the individual Local Authority Limit over one year to £40m per authority and remove the total Local Authority Limit.
iv. Revise the minimum credit rating from A / F1 to A- F2.

7.3 Short-Term Borrowing

7.3.1 Currently there is little return (approximately 0.35%) gained from investing over a short-term period and therefore the focus of the investment strategy will be to take advantage of investments over the medium term (one to three years) where returns of 1.0% to 1.82% is available.

7.3.2 In addition, there is a significant difference of approximately £40m between the Councils highest cash balance in February to June and its lowest cash balance in December to January. To take advantage of medium term investment opportunities as they arise and to allow the Council to smooth the volatility of its cash flow, without overly relying on short-term investments, it will be necessary for the Council to carryout short-term borrowing. Where short-term borrowing is required this will be secured as early as possible to ensure liquidity risk is reduced. Short-term borrowing will also predominantly be from other Public Sector bodies.

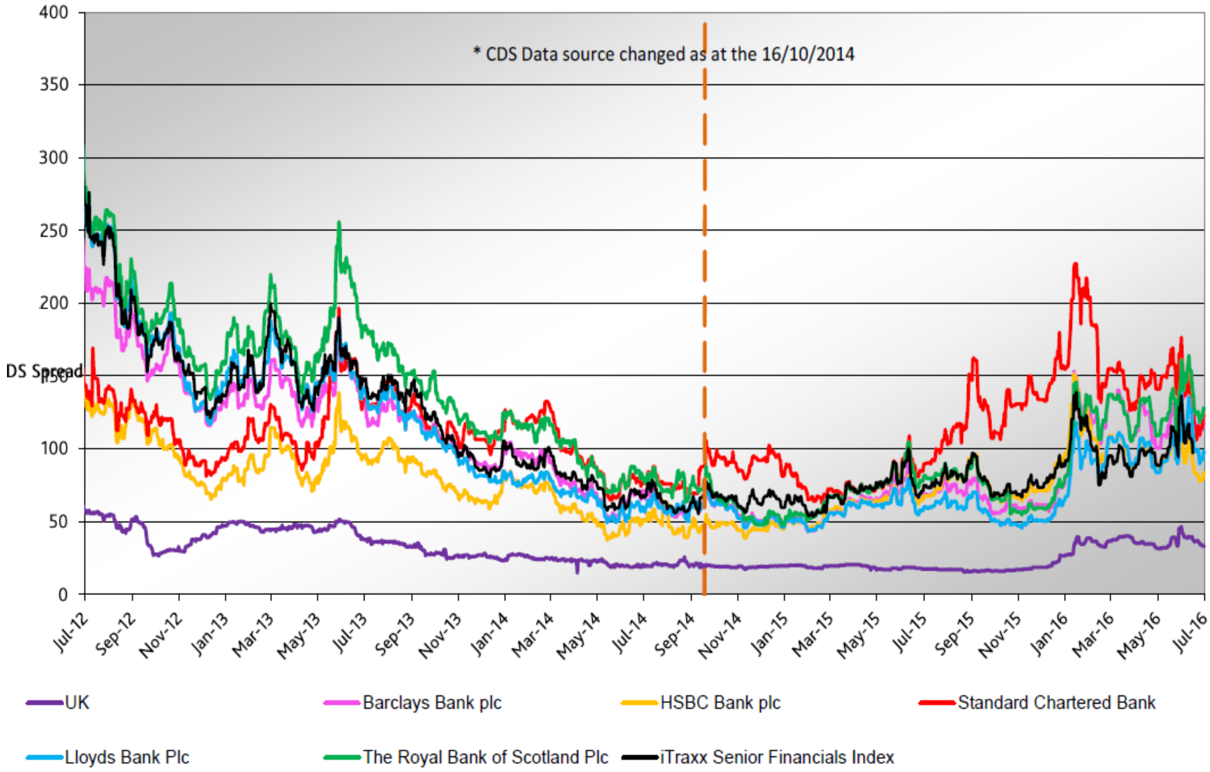
7.4 **Lloyds Banking Group**

7.4.1 The Council has, over the past three years, held a high allocation to Lloyds Banking Group (Lloyds) as it was viewed as having an implied guarantee from the UK government, which held a significant number of Lloyds shares. On 29 October 2015, the Government reduced its holdings of Lloyds shares to less than 10%, with a view to sell the remaining shares as soon as possible. As a result, the Council's exposure to Lloyds was reduced to £34.5m as at 29 January 2016.

7.4.2 In the 2016/17 TMSS, as part of the overall investment strategy of taking more risk, the duration for investment with Lloyds was maintained at 3 years, with a limit of £65m. The Council's Treasury Advisors, suggested investment duration with Lloyds is currently 6 months.

7.4.3 In terms of the rating agencies, Fitch's long term rating for Lloyds is A+, which is equivalent to Moody's rating of A1. All three agencies affirm a stable medium term view on Lloyds at present. Chart 1 shows the movements in CDS for the main UK banks, including Lloyd's CDS prices over the past 5 years compared to the iTraxx. The graph highlights the decrease in Lloyds' CDS prices over the past five years to below the iTraxx benchmark.

Chart 1: Lloyd's CDS prices (2012 to 2016) benchmarked against the iTraxx



7.4.4 In terms of outlooks, all three ratings agencies changed their methodologies mid-2016, which saw alterations to Lloyds' outlook positions. Moody's revised their bank methodology and changed their outlook on Lloyds to positive on 05/06/2016. Moody's placed Lloyds in the group of other UK banks which they believed to reflect a positive trend, more importantly in terms of the bank's capital and asset quality, but also in terms of their profitability.

7.4.5 S&P changed its outlook on Lloyds to stable on 29/07/2016 to reflect their view that Lloyds over the next two years will continue to build its capital buffer and will see improvements to its statutory earnings. Further, they believe that Lloyds will maintain a risk-adjusted capital ratio in line with S&P's ratio of around 8.5-9% and while they believe asset growth will continue, they do not expect this to be at the expense of any increase in risk appetite. Similarly, on changing its rating methodology, Fitch changed its rating outlook for Lloyds to stable on 14/05/2016 despite the negative outlook on their issuer ratings, with this being primarily as Lloyd's bond prices were significantly above their 'a-' viability rating at the time.

7.4.6 As the Authority is considering taking on more credit risk by lending longer than CAS's suggested 6 months, the long-term ratings are more relevant than the short-term ratings. The current definition (and therefore the credit opinion) of the rating agencies based on the above long-term ratings are as follows:

	Fitch	**Moodys**	**S&P**
Long Term Rating:	**A+**	**A1**	**A**

Definition of Long Term Rating: Very high credit quality Superior credit quality. Possibly more prone to adverse effects of changes in circumstances than higher-rated categories.

7.4.7 The justification for differing from the CAS limits is outlined below:

On 1 November 2016, stress tests were conducted and Lloyds comfortably passed these tests. In general, the stress tests had the greatest impact on those banks with significant international and corporate exposures. The three banks operating principally in domestic markets, Lloyds Banking Group, Nationwide and Santander UK, remained well above their hurdle rates throughout the stress.

Currently all Lloyds ratios and stress testing results confirm that Lloyds is one of the strongest UK banks and is ranked the 14th largest bank in the world by market capitalisation. Lloyds has one of the lowest CDS of all financial institutes and has a high tier 1 capital (core equity capital compared to total risk weighted assets) of 13.5%, which is higher than any other UK bank and provides a significant buffer if there were to be a run on the bank. It performed very well in the recent stress tests and is rated A+ by Fitch (marginally behind HSBC at AA-).

There remains a risk from bail-in but Lloyds would need to write-off £52.8b (mainly mortgages and small business loans) before unsecured senior creditors (the Council) would be affected. That would mean that the equity and sub debt would need to be wiped out before the Council's investments would be affected. This is a bigger loss than the loss incurred when Lloyds absorbed HBOS and is a very unlikely scenario.

7.5 **HRA Investments**

7.5.1 Cash balances held by the HRA will be invested as part of the Council's overall treasury strategy. Cash balances will generally earn the average short-term rate of the Council's investments, which will be calculated at the financial year end.

7.5.2 Where there is agreement between the Chief Operating Officer (COO) and the Strategic Director Growth and Homes, individual investments can be ring-fenced for the HRA, with the allocations made within the Council's overall treasury strategy requirements.

7.5.3 For further details please refer to the HRA Business Plan.

7.6 **Derivatives**

7.6.1 The use of derivative financial products will continue to be excluded from the strategy.

8. The Capital Expenditure Plans 2017/18 – 2018/19

8.1 The Council's Housing (HRA) and General Fund (GF) capital expenditure plans, together with Balances and Reserves, are the key drivers of treasury management activity. The estimates for Capital expenditure, and its funding based on current proposed Revenue Budget and Capital Programmes, are reflected in prudential indicators, which are designed to assist Members overview and confirm capital expenditure plans. The Prudential Indicators are included in Appendix 1A of this report.

8.2 Table 5 below shows the proposed capital expenditure over the coming three financial years. It is a requirement of the Prudential Code to ensure that capital expenditure remains within sustainable limits and to consider the impact on Council Tax and, in the case of the HRA, housing rent levels.

Table 5: Proposed Capital Expenditure 2017 to 2020

Capital expenditure	2015/16	2016/17	2017/18	2018/19	2019/20
	Actual £000	Estimate £000	Estimate £000	Estimate £000	Estimate £000
General Fund	63,180	136,427	91,459	17,472	10,400
HRA	82,867	62,659	80,654	59,440	57,960
Total	**146,047**	**199,086**	**172,113**	**76,912**	**68,360**
Financed by:					
Capital Grants	52,534	79,067	56,077	6,000	0
Section 106	529	177	1,000	0	0
Revenue Contributions	4,771	4,104	1,000	400	400
Capital Receipts	30,853	382	14,232	2,200	21,500
HRA Contributions	38,961	62,199	65,132	57,240	36,460
Sub-Total	**127,648**	**145,930**	**137,441**	**65,840**	**58,360**
Net financing need for the year	**18,399**	**53,156**	**34,672**	**11,072**	**10,000**

8.3 The estimated financing need for the year in Table 5 represents a shortfall of resources resulting in a requirement to borrow. This underlying need to borrow is the CFR. The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

8.4 A portion of the net financing need has already been borrowed as this relates to the Abbey Road Phase 2 and Gascoigne regeneration schemes which was borrowed from the European Investment Bank in January 2016.

8.5 Other long term liabilities: the above financing need excludes other long term liabilities, such as PFI and leasing arrangements, which already include borrowing instruments.

8.6 Sufficient headroom has been provided within the Authorised Limit on external borrowing to ensure that any major capital investment projects where finance has yet to be finalised, are not restricted by this statutory limit. The limit covers any short term borrowing for cash flow purposes as well as long term borrowing for capital projects, finance leases PFI initiatives as well as any unforeseen incidences where expected capital receipts are not forthcoming due to unexpected economic factors.

8.7 In addition sufficient headroom has been included within the Operational Boundary and Authorised Limit to accommodate borrowing requirements as a result of £250m property investment and £100m land purchases agreed by Cabinet on 15 November 2016 (Minute 72).

9. The Council's Borrowing Strategy and Borrowing Requirement

9.1 The decision to borrow is a treasury management decision and is taken by the COO under delegated powers of the Council's constitution and after consultation with the Group Manager – Treasury and Pensions and the Director of Finance. The key objective of the Council's borrowing strategy is to secure long term funding for capital projects at borrowing rates that are as low as possible. This can result in a trade off of short term returns on deposits to obtain the best possible rate on long term borrowings.

9.2 The Council can borrow funds from the capital markets for several purposes, including:

(i) *Short term temporary* borrowing for day to day cash flow purposes to ensure liquidity. This is likeliest to occur during the midyear period when the Council's cash balances are lowest and Council's own cash may be tied up in longer term investments. The maximum duration for short-term borrowing is one year.

(ii) *Medium term borrowing* to cover construction and development costs where the repayment period is likely to be after the construction of an investment property.

(iii) *Long term borrowing* to finance the capital programme where the Council can demonstrate the borrowing is affordable. The Council receives external funding (e.g. grants, contributions etc.) to meet a large proportion of its capital expenditure but some projects do not attract specific funding. These projects must be funded by the Council from sources such as capital receipts from the sale of property. However, in the relatively recent past, the Council has not had these funds available and therefore has had to borrow. Where the borrowing is to fund a large-scale property development then the duration and repayment will be linked to the cash flows expected to be generated.

9.3 Treasury management, and borrowing strategies in particular, continues to be influenced by the absolute level of borrowing rates and also the relationship between short and long term interest rates. Rate forecasts indicate that interest rates will remain low until 2018 which creates a “cost of carry” between what is paid on the borrowing and what is earned on the investment for any new longer term borrowing. This is because borrowing requirements are generally over a long term period of up to 50 years, while cash is currently being invested for a maximum of a year.

9.4 As a result the Council expects to maintain an under-borrowed position throughout 2017/18. This means that the CFR will not be fully funded with loan debt during the year as cash supporting the Council’s reserves, balances and cash flow will be used as a temporary measure. This strategy is prudent as it reduces the “cost of carry” while investment returns remain low, as well as reduces the Council’s counterparty risk, which continues to be high and is likely to will continue throughout 2017/18.

9.5 As circumstances can change during the year, the COO will monitor interest rates and adopt a flexible approach to any changes. The Council’s borrowing strategy will also give consideration to the following when deciding to take-up new loans:

- Use internal cash balances while the current rate of interest on investments remains low and cash flow forecasts indicate that borrowing is not required;
- Consideration given to weighing the short-term advantage of internal borrowing against long term costs if long term borrowing rates increase more than forecast;
- Using PWLB, the EIB or Local Authorities for fixed term and variable rate loans;
- Maintain an appropriate debt balance between PWLB and market debt;
- Ensure new borrowings are drawn at suitable rates and periods; and
- Consider the issue of stocks and bonds if appropriate.

9.6 The Council has £30m of fixed rate Lender’s Options Borrower’s Option (LOBO) loans and all of them will be in their call period during 2017/18. A LOBO is called when the Lender exercises its right to amend the interest rate on the loan at which point the Borrower (the Council) can accept the revised terms or reject them and repay the loan. LOBO loans present a potential refinancing risk to the Council since the decision to call a LOBO is entirely at the Lender’s discretion. Any LOBO called will have the default position of repayment of the LOBO without penalty, i.e. the revised terms will not be accepted.

9.7 **European Investment Bank (EIB) Borrowing**

9.7.1 In 2014/15 Cabinet agreed to borrow £89m from the European Investment Bank (EIB) and £4.5m from the PWLB which will be used as outlined below:

- £66.0m from the EIB to finance the Gascoigne Estate (East) Phase 1;
- £4.5m from the PWLB to fund 50% of 51 private for sale units; and
- £23.0m from the EIB to finance Abbey Road Phase 2.

9.7.2 The EIB borrowing will be a liability for the Council and will be include in the Council's CFR but will then be placed within a Special Purpose Vehicle (SPV), which will then be used to manage the repayment of the borrowing and interest as well as the funding of the regeneration of the Gascoigne Estate (East) Phase 1 and the Abbey Road Phase 2. The SPV will pay for these costs through the rental returns generated.

9.7.3 Although investment decisions will be made on behalf of the SPV, with interest returns paid to the SPV, as the risk will remain with the Council, any investment will need to be made within the parameters set within this report.

9.7.4 The drawdown of the full £89m was completed on 30 January 2015 at a rate of 2.207%. The £4.5m proposed to be borrowed from the PWLB will now be borrowed using internal borrowing.

9.7.5 To allow treasury to maintain flexibility to manage the increase in cash it is recommended that Members agree to maintain the authority delegated to the COO, in consultation with the Cabinet Member for Finance, Growth and Investment, to proportionally amend the counterparty lending limits agreed within the TMSS to consider the initial increase in cash from the EIB but also the subsequent decrease in cash balances as payments are made to the SPV.

9.8 Green Investment Bank (GIB) Borrowing

9.8.1 At its meeting on 2 December 2015, the Assembly agreed to borrow £7.5m from the GIB arising from the Cabinet's decision under Minute 67 (10 November 2015) to finance the Low Energy Street Light Replacement Programme via the UK GIB Green Loan.

9.8.2 On 15 December 2016, a loan of £7.0m was borrowed from the GIB at a rate of 3.44% for a duration of 30 years. The borrowing will be over a two-and-a-half-year period and will match the forecast expenditure. The repayment of the loan has been structured to best match the cashflows expected to be generated from the energy savings.

9.9 HRA Self Financing

9.9.1 Central Government completed the reform of the HRA subsidy system on 28 March 2012. The Council is required to recharge interest expenditure and income attributable to the HRA in accordance with Determination issued by the CLG.

9.9.2 The Determinations do not set out a methodology for calculating the interest rate to use in each instance. The Council is therefore required to adopt a policy that will set out how interest charges attributable to the HRA will be determined. The CIPFA Treasury Management Code of Practice recommends that authorities present this policy in the annual TMSS.

9.9.3 The Council has adopted a two loans pool approach for long term debt.

- The full £275.9m of PWLB long term debt from the HRA reform settlement is allocated to the HRA, with the remaining £179.0m of debt (including EIB borrowing) allocated to the GF; and

- All future long term loans are allocated into either the HRA or GF pool.

9.9.4 A breakdown of the HRA borrowing is provided in table 5 below:

Table 5: HRA borrowing:

Loan Type	Loan Amount	Maturity profile	Interest Rate
	£'000s	Yrs	%
PWLB	50,000	25	3.51
PWLB	50,000	35	3.52
PWLB	50,000	43	3.49
PWLB	50,000	44	3.48
PWLB	65,910	45	3.48
Barclays	10,000	61	3.98
Total	**275,910**		

9.9.5 The HRA debt cap is currently set at £277.65m; however, the Council has recently been given approval from the Department for Communities and Local Government, to exceed this by £3.2m in 2017/18 and by a further £10.75m in 2017/18, making the new total cap £291.60 onwards from 2017/18.

9.10 Repayment of Borrowing

9.10.1 As short term borrowing rates are usually cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, any savings will need to be based on the current treasury position and the size of the cost of debt repayment (premiums incurred).

9.10.2 The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings;
- helping to fulfil the treasury strategy; and
- enhance the balance of the portfolio (amend the maturity profile).

9.10.3 No long-dated loans are proposed to be repaid in 2017/18.

9.10.4 Internal borrowing can also be reduced by generating capital receipts, which will replenish cash balances and in accounting terms be used for financing historic spend rather than for new capital projects.

9.11 Policy on borrowing in advance of need

9.11.1 The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved CFR estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

9.11.2 Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

9.11.3 Given that the Council has held a significant under borrowing position over the past years, the borrowing of £89 million from the EIB has not resulted in the Council borrowing in advance of its needs.

9.11.4 Current forecasts indicate that it is unlikely that the Council will seek to borrow in advance in 2017/18.

9.12 Council Transformation Programme - Be First Loan

9.12.1 At the November 2016 Cabinet, Members agreed to establish a new Council-owned company to manage the delivery of the borough's regeneration agenda, Be First, in line with Recommendation 8 of the report of the independent Growth Commission. The aim of Be First is to accelerate the regeneration of the borough and deliver increased revenues and returns to the Council by using greater flexibilities to attract high-quality staff and create joint ventures with developers than would be available to an in-house Council function.

9.12.2 Be First will be a 100% Council-owned company that is operationally independent of the Council, operating in the same way as a commercial organisation, and being accountable to members through a Shareholder Executive Board. It will encompass all aspects of regeneration and place-shaping for the borough, including not only housing, commercial buildings and infrastructure but also green spaces and other community assets, employment, prosperity and community well-being.

9.12.3 To support Be First cash flow requirements during the first few years of established, Members are asked to agree a loan of up to £3.5m to Be First. The Loan will be at a market rate to be determined at the date of the drawdown.

9.12.4 In addition, Members are asked to agree a loan of up to £150,000 to Traded Services as part of the initial set-up costs.

9.12.5 It is recommended that the Chief Operating Officer, in consultation with the Cabinet Member for Finance, Growth and Investment, are delegated authority to agree contractual terms, including the rate, duration and security for both loans.

9.12.6 If additional loans are required as part of the Council's transformation programme, these loans will be taken to Cabinet for approval.

10. Minimum Revenue Provision Policy Statement

10.1 In accordance with Statutory Instrument 2008 number 414 and new guidance issued by the Government under section 21 (1A) of the Local Government Act 2003 a statement on the Council's policy for its annual Minimum Revenue Provision (MRP) needs to be approved before the start of the financial year.

10.2 The Council are asked to approve the Minimum Revenue Provision Statement set out in Appendix 4.

11. Member and Officer Training

11.1 The CIPFA Code requires the responsible officer, the COO, to ensure that members with responsibility for treasury management receive adequate training in treasury management. Training will be arranged for Members as required. The training needs of treasury management officers are periodically reviewed.

12. Financial Implications

12.1 The financial implications are discussed in detail in this report.

13. Legal Implications

Implications completed by: Paul Feild, Senior Governance Lawyer

13.1 The Local Government Act 2003 (the "Act") requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy which sets out its policies for managing investments and for giving priority to the security and liquidity of those investments. The Council must also 'have regard to' the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities when carrying out its functions under the Act.

13.2 This report sets out the Council's strategies in accordance with the Act.

14. Other Implications

14.1 **Risk Management:** This report has risk management issues for the Council, primarily that a counterparty could cease trading or risk that interest rates could rise adversely. The mitigation of these is contained in this report.

Public Background Papers Used in the Preparation of the Report: None

List of appendices:

- Appendix 1 – Annual Investment Strategy and Creditworthiness Policy 2017/18
- Appendix 2 – Interest Rate Forecasts 2017 – 2020
- Appendix 3 – Prudential Indicators 2016/17 – 2019/20
- Appendix 4 – Minimum Revenue Provision Policy Statement 2017/18
- Appendix 5 – Treasury Management Scheme of Delegation and Section 151 Officer Responsibilities